DEC 26 1945
CHARLES ELMORE CROPLEY

IN THE

Supreme Court of the United States

OCTOBER TERM, 1945

No. 686

LOUIS LOBER,
Petitioner (Appellant below),

v.

CANADIAN PACIFIC RAILWAY COMPANY; EDWARD A. WHITMAN and P. L. SOLETHER, Trustees for The Duluth, South Shore and Atlantic Railway Company, Debtor, and for the Mineral Range Railroad Company, Secondary-Debtor; CENTRAL HANOVER BANK AND TRUST COMPANY, as Trustee under First Consolidated 4% 100-Year Mortgage of the Debtor; and JOHN R. HATTSTAEDT, et al., Protective Committee for Debtor's First Mortgage 5% Gold Bonds due January 1, 1937,
Respondents (Appellees below).

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT, AND BRIEF IN SUPPORT THEREOF.

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Petitioner (Appellant below),

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CANADIAN PACIFIC RAILWAY CO.
Respondent et al. (Appellees below).

No.....

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

TO THE HONORABLE HARLAN F. STONE, THE CHIEF JUSTICE, AND THE ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

LOUIS LOBER, appellant below, the above named petitioner, respectfully prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Eighth Circuit filed on the 6th day of November, 1945, which affirmed the order made in the United States District Court for the District of Minnesota, Fourth Division (Nordbye, J.), on the 31st day of January, 1945, which denied the petition of the petitioner for a determination in this proceeding for the reorganization of the Duluth, South Shore & Atlantic Railway Company (hereinafter called "South Shore") that the claims of Canadian Pacific

Railway Company (hereinafter called "Canadian") be subordinated to the claims of the owners of the Debtor's First Mortgage 5% Bonds (hereinafter called "the 5s").

The petition in the District Court is based upon, what is clearly to us, an over-reaching transaction carried out by Canadian under an agreement dated May 22, 1936, made by it with its subsidiary South Shore, which abrogated a covenant previously made by Canadian with South Shore for the benefit of the public holders of the 5's respecting the guarantee by Canadian of interest.

The reorganization petition was filed by the Debtor on January 2, 1937, and directly thereafter an order was made by the District Court allowing the petition and appointing trustees, since when the Debtor has remained in the hands of the District Court for reorganization.

Thereafter, a suit was brought in said District Court entitled *"McCulloch* vs. *Canadian Pacific Railway Company"*. This suit was by a holder of the 5's and sought to enforce the rights of the holders of the 5's as third party beneficiaries under the covenant which had been made by Canadian for their benefit. During the pendency of the case the District Court from time to time entered orders in the bankruptcy proceeding extending the time of the Debtor to file a plan. That case was tried before Judge Nordbye, who in June, 1943, made a decision dismissing the suit (see 53 F. Supp. 534). As correctly stated in the District Court's memorandum decision the judgment in the *McCulloch* case is not binding upon this petitioner since he was not a party to that suit (R., 68).

Thereafter, appellant herein was permitted by the Interstate Commerce Commission to intervene before it (R., 8) and then was permitted by the District Court to intervene

in this proceeding (R., 10). Thereupon the appellant filed his petition asking that the claims of Canadian be subordinated to the claims of the holders of the 5's.

Appellant's petition was filed pursuant to Rule 42(b) for the separate trial of the issue presented, the determination of which is essential to a solution of the basic question in this reorganization proceeding, viz: whether or not the claims of Canadian should be subordinated to the claims of the holders of the 5's. The procedure thus adopted is fully supported by authority. See: *Elias* vs. *Clarke,* 143 F.(2d) 640, 644.

The issue thus presented by us was submitted to the Court upon admitted pleadings or, in effect, upon an agreed statement of facts (Pleadings R., pp. 11-41. Briefly stated, the essential facts thus adduced are as follows:

FACTS

South Shore was organized in 1886-87. In 1887 $4,000,000 of First Mortgage 5% Bonds were issued by it and sold to the public and, except that many years ago Canadian acquired $184,000 of the bonds and converted them into Consolidated 4% Bonds, the whole issue, viz., $3,816,000, remained in the hands of the public up to the date of the filing of the petition herein (R. 15). The bonds owned or represented by petitioner are a part of this issue.

About 1888 Canadian acquired more than a majority of the capital stock of South Shore (R., 12). Canadian was also given control of the management of South Shore by the express provisions of the Traffic Agreement hereinafter referred to (R., 47).

South Shore's Railroad runs between Duluth and Sault Sainte Marie and skirts the South Shore of Lake Superior.

The middle and the more valuable portion of its railway is the line of the Marquette, Houghton & Ontonagon Railroad Company (hereinafter called Marquette), which South Shore at the time of the making of the $4,000,000 First Mortgage Bond issue held under a perpetual lease, which perpetual lease was expressly subject to the mortgage securing the 5% Bonds (R., 12).

On May 27, 1890, Canadian entered into an agreement with its subsidiary South Shore entitled "Traffic Agreement" (R., 47) which provided for the delivery by South Shore to the lines of Canadian of the freight originating on South Shore's Railway (R., 50) and that so long as South Shore should be in default* in the payment of interest on any of its bonds Canadian had the power to appoint its managing officer (R., 53). The agreement restricted the right of South Shore to create other liens (R., 53); required the account books of South Shore to be put into conformity with the account books of Canadian and put South Shore's accounting system under the inspection and control of Canadian (R., 53) and prohibited South Shore from constructing or being interested, directly or indirectly, in the construction or operation of any line in competition with the line of Canadian (R., 54). In short, this agreement, in effect, provided that South Shore was to be thenceforth operated as a mere adjunct of Canadian. From 1888 on until the filing of the petition herein Canadian through the exercise of its power as the owner of a majority of the voting stock of South Shore selected South Shore's board of directors (R., 13).

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*Soon after 1890 South Shore went into default upon the payment of interest on its Consolidated Bonds hereinafter mentioned and remained in default thereon until the filing of the petition herein.

The Traffic Agreement also made provision for the making of a new mortgage called the Consolidated 4% Mortgage dated 1890 for the security of an issue of $20,000,000 of 100 year 4% bonds and provided for the holding of sufficient of these bonds for the purpose of exchange, bond for bond, for the 5's at the option of the holders of the 5's at any time "at or before the maturity" of the latter, viz, until January 1, 1937 (R., 50, 51), and it contained a covenant by Canadian which provided that

> "* * * as fast as the said new four per cent. (4%) mortgage bonds are exchanged for any of the said outstanding bonds * * *, the latter Company (Canadian) will execute a guaranty, under its corporate seal, upon the new bonds so issued, * * * for the payment of interest thereon, during the entire term thereof, at the rate of four per cent. (4%) per annum, payable semi-annually, from the time that such bonds are * * * exchanged."*

(See Article Fifth of the Traffic Agreement, R., 52.) A conditional clause appearing at the beginning of this article was complied with (R., 46).

As a part of this same transaction the perpetual lease of the Marquette Line to the South Shore was surrendered and its railway thus removed from the lien of the mortgage securing the 5's and such issue of $20,000,000 4% Consolidated Bonds was then inserted as a lien upon the Marquette Line and after the insertion of this lien the Marquette Line was then conveyed in fee to South Shore subject, however, to this new $20,000,000 mortgage (R., 13, 14). In other words, prior to the issuance of this $20,000,000 mortgage, the perpetual lease of the Marquette Line, secured the $4,000,000 5% First Mortgage, but, after the $20,000,000 mortgage was made, the $4,000,000 mortgage became subject to the prior lien of the $20,000,000 mortgage on the Marquette Line.

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*This covenant applied not only to the First Mortgage 5% bonds of the debtor but applied also to several outstanding issues of bonds of Marquette.

As a further part of this transaction $2,000,000 of the new Consolidated Bonds were issued to Canadian without any consideration therefor except its entering into the Traffic Agreement (R., 14).

Through subsequent acquisition by Canadian of the outstanding securities of Marquette, as well as the acquisition of $184,000 of the First Mortgage 5's of South Shore and the exchanging thereof for the Consolidated 4's, as well as the acquisition of the $2,000,000 of 4's received as part of the considerations under the Traffic Agreement and of additional 4's in consideration for advances made from time to time Canadian acquired ownership of more than $15,000,000 of the 4's. This, with many years of defaulted interest thereon amounted to an aggregate of more than $40,000,000, for which Canadian has filed its claim as a creditor herein assenting a prior lien on the Marquette Line (R., 16).

The only claimants who have a right to participate in a reorganization herein are the public owners of the outstanding $3,816,000 of 5's and Canadian (R., 16).

Interest on the outstanding 5's was regularly and promptly paid up to the date of filing of the petition and none of the publicly owned 5% bonds were exchanged for the 4% bonds (R., 15).

In this setting Canadian entered into an agreement dated May 22, 1936 with its subsidiary South Shore, called "Supplement to the Traffic Agreement", which sheerly provided that "any provisions thereof (the Traffic Agreement referred to above) which required the Pacific Company (Canadian) to execute a guaranty of interest upon said bonds, are hereby abrogated and shall be of no further effect," (R., 14). Admittedly, neither South Shore nor

Canadian notified the holders of the Fives of the abrogation either before or after the event.

Canadian did this in contemplation of having its subsidiary file at the end of the year the reorganization petition which was then filed (R. 30, 69).

On May 22, 1936, South Shore was insolvent (R., 15).

This overreaching transaction abrogating Canadian's guaranty covenant speaks for itself. There are, however, additional conceded facts showing in some detail the steps which were taken in connection with the making of this so-called "Supplement to the Traffic Agreement". The idea was set in motion by a letter of Mr. Mitchell, as counsel for South Shore, to Mr. Jaffray, as President, under date of April 15, 1936. It says:

> "Since the present D. S. S. & A. First Consolidated Mortgage of July 17, 1890, is unsuitable for further financing and will have to be eliminated in the approaching reorganization * * *.
>
> "I therefore suggest that the traffic agreement of May 27, 1890, between the Canadian Pacific and the DSS&A should be amended so as to eliminate its provisions for the Canadian Pacific guaranty of further issues of bonds under the above Mortgage; * * *" (R., 30).

This letter was responded to not by Mr. Jaffray but by a telegram dated April 23, 1936 addressed to Mr. Mitchell by Mr. Flintoft, General Counsel of Canadian which closed with the following words:

> "However as you are much more familiar with whole history of these transactions would appreciate full explanation of grounds for your recommendation in

matter. Stop. In any case I agree with you that if course of action outlined can legally be taken it is desirable" (R., 30).

This was followed by a meeting of some of the members of South Shore's board of directors. Conspicuously absent from the meeting were Mr. Jaffray, a director and president, Mr. Wallace, a director and vice president, and Mr. Webster, a director. These three gentlemen constituted the Executive Committee of South Shore. They also were, respectively, the President, Vice President and General Manager and Vice President of the Soo Line, of which Canadian was the owner of a majority of the capital stock (R., 40). Those present were Mr. Urbahns, Debtor's manager, a Mr. Bice, vice president of a bank at Marquette, a Mr. Lytle, a retired superintendent of South Shore, a Mr. Wiedman, president of a lumber company at Trout Creek, Michigan, a Mr. Phelps, associated with an insurance agency in Marquette, and a Mr. Ferguson, a hardware merchant of Sault Ste. Marie. At the meeting the proposed resolutions, which had been previously prepared, together with the form of Supplement to the Traffic Agreement, as well as of a Supplemental Indenture for the closing of the mortgage securing the 4's, were put before these members of the board who, on motion of Mr. Bice, seconded by Mr. Wiedman and, as the minutes show, without discussion, unanimously adopted the resolutions. Directly thereafter the Supplement to the Traffic Agreement was executed (R. 31-34).

Since the opinion of the Court of Appeals (R., 93) comments upon the fact that the Bondholders' Committee instituted a proceeding to inquire into the entire relation-

ship between Canadian and South Shore from the time Canadian acquired control of South Shore in 1888 until the filing of the reorganization petition on January 2, 1937, for the purpose of ascertaining whether there should be a subordination and that this proceeding is still pending, we think it is right that this Court should know that the Bondholders' Committee, which represents the holders of between 800 and 900 of the 5's, rather than intending to pursue this inquiry, has arrived at an understanding in writing with Canadian as to the terms of a plan; that this written agreement has been lodged by the Committee and Canadian with the attorney for the Debtor with the request that the Debtor file a plan in accordance therewith, assurance having been given that both Canadian and the Committee will thereupon adhere to such plan; that the basis of such plan is the issuance of $5,000,000 of 4% income bonds and 210,000 shares of capital stock; that $400,000 of cash and $2,000,000 in face amount of the new 4% income bonds are to be distributed amongst the holders of the 5's at the rate of $100 in cash and $500 in bonds for each $1,000 of the 5's, the remaining $3,000,000 of these income bonds and all of the capital stock to go to Canadian.*

During the period since the filing of the petition the Debtor has much more than earned the interest upon the 5's at the stipulated rate of 5%. There is now in the hands of the trustees accumulated earnings in the form of cash

*The foregoing statement is based upon an inspection of said written agreement when it was called to the attention of the District Judge by counsel for the Committee and Canadian in October, 1944, in the presence of counsel for the Petitioner. In December, 1945, counsel for the Petitioner inquired of counsel for the Debtor as to the accuracy of the foregoing statement and counsel for the Debtor responded that he was under a pledge of secrecy to counsel for the Committee and Canadian and that he would neither affirm nor deny the accuracy of our statement.

or United States Bonds or treasury certificates substantially exceeding $3,000,000. Except for the payment in 1944 of one year's interest, the holders of the 5's have received nothing since Jan. 2, 1937, the date of the filing of the reorganization petition.

THE FINDINGS

On March 12, 1945, after the making by the District Court of the order appealed from and after the taking of the appeal, the Court made brief findings (R., 59-63). Since the case was submitted upon admitted facts, these findings were uncalled for (see *United States Trust Company* vs. *Sears,* 29 F. Supp. 643).

Finding II (R., 60) construes the Traffic Agreement and arrives at conclusions as to what the parties intended and did not intend in respect of several important matters.

The construction of written instruments is a question of law, and this so-called finding of fact should be regarded as a conclusion of law rather than a finding of fact. *Anson on Contracts* (5th ed.), Section 354 at page 439:

> "* * * the construction of a contract is always a matter of law for the court to determine."

26 *Ruling Case Law* 1091:

> "In determining the character of a finding the court will look to the substance thereof rather than its classification. Conclusions drawn by the court from facts found by it are conclusions of law, though denominated findings of fact."

However regarded the so-called finding is plainly erroneous as will appear from the annexed brief.

Finding IV (R., 61) is to the effect that the petitioner, or the other holders of the 5's represented by him, did not rely on the guaranty covenant. The fact of lack of reliance

by the holders of the 5's is given emphasis by the court in its memorandum decision herein, as well as in its opinion in the *McCulloch* suit. While this finding is correct the court has much overstressed the importance of this. Clearly, upon the reorganization of this corporation, the holders of the 5's are not going to be classified into sheep or goats according to whether they as individual bondholders are able to establish that they did so rely. Certainly the bondholders who became such before 1890 or who acquired their interests as heirs or legatees of early holders could, in the nature of things, never establish that their bonds were acquired in reliance upon the guaranty covenant for the simple reason that it was not in existence at that time. In a word, it must be that a plan fair to the holders of the 5's will be regarded as such for all of them as a class.

Finding V (R., 61) which is to the effect that Canadian did not "control or dominate South Shore" and that the Supplement to the Traffic Agreement was not brought about through the exercise of Canadian's dominion is an ultimate conclusion as to a vital question. Since it was drawn from conceded facts it is a conclusion of law rather than a finding of fact. It is contrary to the conceded facts which, compel the ultimate conclusion that the Supplement to the Traffic Agreement was entered into by South Shore at Canadian's behest.

Finding VI (R., 62) that "Canadian Pacific was not in any way responsible for the financial involvements of South Shore" is contrary to the fact that it has been fully apparent throughout this reorganization proceeding that Canadian did not finance its subsidiary by furnishing junior capital but by making interest bearing loans, with the result that it filed a claim as a creditor for more than $40,000,000

covering the principal and many years of interest on its loans. Manifestly this method of procedure contributed to the financial involvements of South Shore, and, indeed, is what made it insolvent.

Finding VII (R., 62) to the effect that Canadian's promise under the Traffic Agreement to execute its guaranty of interest on 4's exchanged for prior bonds was not an asset of the Debtor on May 22, 1936 is not strictly correct. But whether correct or not, this right which South Shore held for the benefit of the public owners of its bonds was a thing of very great value for the protection of their interests. The gratuitous surrender of it by the debtor at the behest and for the benefit of its parent Canadian was a grave fraud upon its creditors.

THE QUESTIONS PRESENTED

1. Should not the Courts below have determined that, upon a reorganization of the Debtor, the claims of respondent, Canadian Pacific Railway Company should be subordinated to the claims of the holders of the First Mortgage 5% Bonds of the Debtor.

2. Should not the Courts below have held that the holders of the First Mortgage 5% Bonds of the Debtor had enforceable legal rights as third party beneficiaries under the covenant made by respondent, Canadian Pacific Railway Company, in the Traffic Agreement between it and its subsidiary, the debtor, dated the 27th day of May, 1890, by which Canadian Pacific Railway Company covenanted that it would guarantee the interest upon the 4% Bonds of the Debtor as exchanged for said 5% Bonds of the Debtor and

that the rights of said holders of said 5% Bonds were, at least after the insolvency of the Debtor, indefeasible.

3. Should not the Courts below have held that respondent, Canadian Pacific Railway Company, stood in a fiduciary relation to the public holders of said 5% First Mortgage Bonds of its subsidiary corporation, the Debtor, and that the making by it with its subsidiary, the Debtor, of the Supplement to the Traffic Agreement dated May 22, 1936 abrogating its said covenant for the guarantee of interest, in contemplation of the filing by the Debtor of the reorganization petition which was thereafter filed, was an overreaching and fraudulent act and a breach of its fiduciary duty.

THE REASONS FOR THE ALLOWANCE OF THE WRIT

1. The courts below decided the questions presented in a way in conflict with the applicable decisions of this Court, particularly *Taylor* v. *Standard Gas & Electric Co.*, 306 U.S. 307, 83 L. Ed. 669; *Consolidated Rock Products Co.* v. *DuBois*, 312 U.S. 510; 85 L. Ed 982; *Case* v. *Los Angeles Lumber Co.* 308 U.S. 106; 84 L. Ed 110; and *Prudence Realization Corp.* v. *Geist*, 316 U.S. 89; 86 L. Ed. 1293.

2. The courts below failed to heed the admonitions of this court, particularly by said decisions in *Taylor* v. *Standard Gas & Electric Co.* and *Consolidated Rock Products Co.* v. *DuBois*, that, in passing upon the reorganization of corporations, the courts should scrutinize critically the conduct of a parent corporation which has cast its subsidiary into the hands of the federal courts for reorganization, especially where the parent comes forward with large claims

as a creditor in competition with the public owners of the securities of such subsidiary.

3. The Courts below disregarded applicable decisions of this court which hold that a parent corporation has fiduciary duties to the public owners of the securities of its subsidiary, which fiduciary duties should be strictly enforced, particularly the decisions of this court in *Taylor* v. *Standard Gas & Electric Company* and *Consolidated Rock Products Co.* v. *DuBois.*

4. The decisions of the courts below conflict with the decisions made in other Circuit Courts of Appeals, viz.:

Hanssen v. *Wingren,* 121 F. (2d) 1011 (C. C. A., 10th, 1941);

In re American Fuel & Power Co., 122 F. (2d) 223 (C. C. A., 6th, 1941);

Stone v. *Eacho,* 127 F. (2d) 284 (C. C. A., 4th, 1942);

In re Commonwealth Light & Power Co., 141 F. (2d) 734 (C. C. A., 7th, 1944).

IMPORTANCE OF THE QUESTIONS

It is most important that this court review the decision of the Circuit Court of Appeals for the following chief reasons:

In the case of *Consolidated Rock Products Co.* v. *DuBois,* the unanimous opinion of this court clearly shows the importance which this court attaches to having the lower courts understand their duties in dealing with situations such as the instant situation where a parent corporation

causes its subsidiary, the securities of which are outstanding in the hands of the public, to be cast into the hands of the federal courts for reorganization, and then comes forward to urge on its own behalf in the reorganization proceedings claims in competition with the claims of the public owners of the subsidiary's securities. As shown in the opening paragraph of this court's unanimous opinion in that case, the court there granted the petitions for certiorari "because of the importance in the administration of the reorganization provisions of the Act of certain principles enunciated by the Circuit Court of Appeals." This court then set forth the principles which should guide the lower courts in such circumstances and reaffirmed its views previously expressed in that regard in its previous decision in *Taylor* v. *Standard Gas & Electric Company.*

The decisions of the courts below are glaring examples of disregard of the views of this court as expressed in those decisions. The overreaching act of the parent, Canadian Pacific Railway Company, in sheerly abrogating the subsisting covenant which it had previously made with its subsidiary for the benefit of the public holders of the bonds of its subsidiary at a time when, admittedly, it was contemplated by the parent corporation that it would cast its subsidiary into the hands of the court for reorganization, was perpetrated manifestly for the purpose of thus getting rid of an obligation which, if left in force, would have resulted in Canadian standing in a position of guarantor to the public holders of the bonds. This, under long established principles of distribution in bankruptcy, would have placed it in a position of subordination to the public owners of the securities of its subsidiary. See *Prudence Realization Corp.* v. *Geist.*

This single overreaching transaction was manifestly aimed by the respondent, Canadian Pacific Railway Company, directly at the public holders of the securities of its subsidiary and for the plain purpose of affecting injuriously their position as claimants in competition with the overshadowing claims as creditor which Canadian then intended and did put forward in the then contemplated reorganization proceedings.

This act of abrogating this covenant which it had made with its subsidiary for the benefit of the public holders of the bonds of its subsidiary, considered in the light of the reorganization proceedings which followed, shows that the respondent thus sought to obtain judicial sanction to a scheme to write down the public debt of its subsidiary corporation while continuing to remain in complete ownership thereof, subject only to this public debt as so written down.

The jurisdiction of the court was invoked in the reorganization proceedings for the purpose of destroying the rights of creditors rather than protecting them. As said by this court in *First National Bank* v. *Flershem,* 290 U. S. 504, 78 L. Ed. 465, in condemning the steps which were taken by a District Court in effectuating a reorganization plan: "The power of the District Court was invoked, not to enforce rights of creditors, but to defeat them."

The warnings and admonitions so carefully made by this court in respect to the conduct by the lower courts of reorganization proceedings in situations such as this will be in danger of going for naught if the decisions of the courts below are permitted to stand.

WHEREFORE, it is respectfully submitted that this petition for a *writ of certiorari* to review the judgment of the Circuit Court of Appeals for the Eighth Circuit dated the 6th day of November, 1945, and the order of the United States District Court for the District of Minnesota, Fourth Division, dated the 31st day of January, 1945, which was affirmed by the judgment of the Circuit Court of Appeals, should be granted.

LOUIS LOBER, *Petitioner*

By RALPH ROYALL
FREDERICK H. STINCHFIELD
Counsel for Petitioner.

PETITIONER'S BRIEF

BRIEF IN SUPPORT OF PETITION

OPINIONS OF THE COURTS BELOW

The opinion of Judge Nordbye in the District Court is reported in 58 Fed. Supp. 733. The opinion of the Circuit Court of Appeals has not as yet been reported. The opinion of Judge Nordbye is printed at page 63 of the Record. The opinion of the Circuit Court of Appeals is printed at page 85 of the Record. The opinion of Judge Nordbye in the case of *McCulloch* v. *Canadian Pacific Railway Company* is reported in 53 Fed. Supp. 534.

JURISDICTION

The jurisdiction to issue the writ is found in Section 240a of the Judicial Code as amended by the Act of February 13, 1925, c. 229, Sect. 1, 43 Stat. 938; Sect. 347a of Title 28, U.S.C.

STATEMENT OF FACTS

The statement set out in the foregoing petition is hereby adopted.

SPECIFICATION OF ERRORS

1. The Courts below erred in refusing to determine that, upon a reorganization of the Debtor, the claims of respondent, Canadian Pacific Railway Company, should be subordinated to the claims of the holders of the First Mortgage 5% Bonds of the Debtor.

2. The Courts below erred in refusing to determine that the holders of the First Mortgage 5% Bonds of the

Debtor had enforceable legal rights as third party beneficiaries under the covenant made by respondent, Canadian Pacific Railway Company, in the Traffic Agreement between it and its subsidiary, the Debtor, dated the 27th day of May, 1890, by which Canadian Pacific Railway Company covenanted that it would guarantee interest upon the 4% Bonds of the Debtor as exchanged for said 5% Bonds of the Debtor and that the rights of such holders of said 5% Bonds were, at least after the insolvency of the Debtor, indefeasible.

3. The Courts below erred in failing to determine that respondent, Canadian Pacific Railway Company, stood in a fiduciary relation to the public holders of the 5% First Mortgage Bonds of its subsidiary corporation, the Debtor, and that the making by it with its subsidiary, the Debtor, of the Supplement to the Traffic Agreement dated May 22, 1936, abrogating its said covenant for the guarantee of interest in contemplation of the filing by the Debtor of the reorganization petition which was thereafter filed, was an overreaching and fraudulent act and a breach of its fiduciary duty.

ARGUMENT

The courts below studiously avoided coming to grips with the essential question presented, viz., whether, because of this overreaching transaction in abrogating its guaranty covenant, which was aimed by Canadian directly at the creditors of its subsidiary, its claim for over $40,000,000 should be subordinated to the $3,816,000 claim of the holders of the 5's.

I.

The Court of Appeals (R. 93, 94) seemed to take the view that, since we predicate our case upon the abrogation transaction and since the issue presented by us does not involve an inquiry into the relationship of Canadian with its subsidiary South Shore throughout the whole period of the many years of its control, the question of the violation of its fiduciary duties does not arise and that the decisions of this Court* upon which we chiefly rely have, therefore, no application. But surely this single overreaching transaction aimed directly by Canadian at the public holders of the bonds of its subsidiary was a clear breach of its fiduciary duty. It, alone, should compel subordination. As guarantor, Canadian should, under the rule of *Prudence Realization Corp.* v. *Geist,* be subordinated.

If this act of Canadian is to be sanctioned by the courts and it is thus permitted to inflict this most serious direct injury upon the holders of the 5's to its own corresponding financial advantage, the public owners of the securities of the subsidiary will suffer a more serious injury than may possibly have resulted from Canadian, throughout the years of its control, having impaired the debtors assets by conducting it more in Canadian's interest than in the interest of the debtor.

The Court of Appeals finally puts aside the decisions of this Court upon which we rely, with the statement that "A corporation is not liable for the acts or the obliga-

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*In citing the decisions of this Court at this point of its opinion the Court of Appeals failed to refer to this Court's decision in *Taylor* vs. *Standard Gas & Electric Co.*, 306 U.S. 307.

tions of another corporation, merely because it controls such other by reason of ownership of its stock." (R. 94) Manifestly this rule of law has no application to the decision of the question here presented, for the simple reason that Canadian was itself a party to the agreement by which its guaranty covenant was abrogated.

II

The Court of Appeals next takes the position (R. 95) that, conceding the holders of the 5's had enforceable third party beneficiary rights, these rights had lapsed because of the passage of time. The District Court took a similar view.

We submit that, in this, the Courts below were clearly in error. The Traffic Agreement expressly provided for the making of the exchange at the option of the holders of the 5's "at or before maturity" of the latter. This right was granted for ample considerations, comprised of the $2,000,000 of 4's which were issued to Canadian, as well as other important considerations which Canadian received under the provisions of the Traffic Agreement. The mere fact that the option to exchange had a long period to run, viz., from 1890 until 1937, could not in the nature of things entitle Canadian to terminate the option before the stipulated time for its termination had arrived. The fact that the stipulated period was a long one did not give the obligor the right arbitrarily to shorten it.

The old New York cases of *Mott* v. *New York S. & T. Co.*, 60 N. Y. S. 357 and *Morse* v. *Chicago & E. I. R. Co.*, 82 N. Y. S. 698 as well as the federal decision in *New York S. & T. Co.* v. *Louisville E. & St. L. C. R.*, 97 Fed. 226 which the courts below relied upon for such a result, are not, as the Court of Appeals says, cases dealing with facts

essentially the same. Those old cases are essentially different. They did not deal with an agreement granting a a privilege to be exercised within a stipulated time. The facts involved in those cases show clearly that there was no time expressly defined for the exercise of the privilege. Those cases merely held that, under the circumstances there existing, the agreement must be construed as intending a reasonable time and that such reasonable time had expired. But in the instant case there is no possible room for a question as to the time within which the holders of the 5's must exercise the right granted to them to make the exchange, for the simple reason that the covenant expressly stipulated for a time which had not expired when the covenant was abrogated.

In discussing the lapse of years during which the holders of the 5's had not availed themselves of the right of making the exchange, the District Court (R., p. 71) took the view that the meaning of the Traffic Agreement of 1890 was that the 5's would be promptly exchanged for the 4's. That Court seemed to entertain the view that the holders of the 5's ought to have cooperated and seemed to put forward the suggestion that there was something inequitable in their not having done so. The Court seemed to have overlooked the fact that there was no proof that the holders of the 5's were ever asked to make the exchange and indeed, in finding that the holders of the 5's did not rely upon the exchange covenant, the Court took the contrary view that the knowledge of this provision of the Traffic Agreement had not been disseminated to the public holders of the 5's.

It seems to us that the Court might more fairly and wisely have concluded that Canadian itself studiously

sought to forestall the exchange of 5's for 4's by constantly, through the whole 47 year period, lending money to South Shore, when required, for the purpose of servicing the interest charges on the 5's.

We cannot understand what the District Court could have had in mind in saying as it did (R., p. 71) "They (the holders of the Fives) could not be required to make the exchange." Manifestly, if the parties had so intended, the agreement could have been made to provide that the exchange had to be made by the holders of the 5's within a fixed short period or not at all. Instead of this the agreement provided for the making of the exchange at any time until January 1, 1937.

The provisions of the Traffic Agreement respecting the exchange of bonds and the making of Canadian's guaranty must have contemplated that the holders of the 5's might not and presumably would not exchange their bonds into bonds bearing a lower interest rate while the stipulated interest at the rate of 5% was being regularly paid, but that, in case interest was defaulted, the holders of the 5's would then exchange them for the 4's so as to have the protection afforded by Canadian's guaranty of interest. In construing the agreement it must be legally presumed that the parties intended the consequences which would naturally flow from it.

Finding of Fact II, (R., 60), which as is shown by our certiorari petition, was inserted by the District Court after the making of the Court's order and the taking by us of the appeal therefrom, seeks to impress upon the agreement a strained construction in these respects. This finding of fact is erroneously described as such by the District Court. Since it involved the construction of an unambiguous

agreement which is a pure question of law, the finding can be properly classified only as a conclusion of law. As such it is plainly erroneous.

III

The Court of Appeals then takes the position (R. 95) that we have misinterpreted the Traffic Agreement. That Court says that the Traffic Agreement does not intend to grant for the benefit of the holders of the 5's any right of exchange at all. This is an entirely new departure by the Court of Appeals and quite contrary to the views expressed by the District Court which clearly took the position that the Traffic Agreement was intended as giving to the holders of the 5's the right to exchange their bonds for 4's containing Canadian's guaranty.

We submit that the Court of Appeals is plainly wrong. As shown by the opinion in the *McCulloch* case, at page 538, and as is admittedly the fact, the 5's were not subject to redemption or call.

Article Fourth of the Traffic Agreement reads (R. 51):

> "Fourth. *The South Shore Company will apply the said bonds* ($20,000,000 of the then newly authorized 4's) to the following purposes, in the following order:
>
> "I. *Four million dollars* ($4,000,000) *par value thereof, to the sole purpose of retiring, at or before maturity, bond for bond, a like amount of first mortgage five per cent.* (5%) *South Shore bonds.*
>
> "II. (A similar provision respecting an issue of $1,400,000 of Marquette bonds.)
>
> "III. So much as may be necessary for that purpose, to retiring the other bonds hereinbefore

mentioned, constituting a lien upon the property of the Marquette Company, at or before their maturity.

"IV. So much as may be necessary to paying off its floating debt and extinguishing the consolidated mortgage now existing.

"V. The residue to the improvement and extension of the South Shore Railway, * * *."

Article Fifth reads as follows (R. 52):

"Fifth. If, within six months after the date hereof, the said new four per cent. (4%) bonds, secured by the said new mortgage or deed of trust are executed, to such amount as may be approved by the Pacific Company, and the surrender of all the bonds issued under the old consolidated mortgage, in exchange for the four per cent. (4%) bonds issued under the new mortgage, to an amount equal to the floating debt and interest secured by such old consolidated mortgage bonds, has been fully assured, then, as fast as the said new four per cent. (4%) mortgage bonds are *exchanged for any of the said outstanding bonds, * * *, the latter Company will execute a guaranty, under its corporate seal, upon the new bonds so issued, but upon no others, for the payment of interest thereon, during the entire term thereof, at the rate of four per cent. (4%) per annum, payable semi-annually, from the time that such bonds are so issued, exchanged or sold.*" (Italics supplied.)

The conditional clause, which precedes the part of Article Fifth in italics, was fully complied with. (See stipulation made at the trial R., 46).

We have it plainly expressed that South Shore "will apply the said bonds" to the extent of $4,000,000 thereof,

"to the sole purpose of retiring, at or before maturity, bond for bond, a like amount of first mortgage five per cent. (5%) South Shore bonds". The agreement to apply the $4,000,000 of 4's to the sole purpose of retiring the 5's "bond for bond" could contemplate nothing else but an exchange. It is difficult to conceive of any method of retiring an uncallable issue of bonds through the application of another issue on a bond for bond basis excepting through the process of exchange.

If there could be any possibility of doubt as to this, the question is completely resolved by the language which follows in Article Fifth where it says:

> "as fast as the said new four per cent. (4%) mortgage bonds *are exchanged* for any of the said outstanding bonds, * * *, the latter Company (Canadian) will execute a guaranty, under its corporate seal, upon the new bonds so issued, but upon no others, for the payment of interest thereon, during the entire term thereof, at the rate of four per cent. (4%) per annum, * * *."

We submit that nothing could be plainer than that these provisions of the agreement intended that the holders of the 5's should have the right "at or before maturity" of their bonds to exchange them for the new 4's bearing Canadian's guaranty as to interest.

This was also the practical construction of the agreement by the parties for, as the record shows, $184,000 of the 5's have been exchanged for the 4's. Furthermore, why did Canadian bring about the abrogation of this covenant, if as the Court of Appeals now says it created no third party beneficiary rights in the holders of the 5's.

IV

Next, the Court of Appeals says (R., 95) "the ability of South Shore to perform its obligations was dependent entirely upon factors beyond the control of either party to the agreement, a fact which must have been recognized by both parties at the time the agreement was made. Canadian's obligation to guarantee interest upon South Shore's Fours was, therefore, contingent upon the ability of South Shore to make the proposed exchange of bonds." The Court then concludes with a non-sequitur that, therefore, Canadian never became bound to South Shore or to any beneficiary of the contract to endorse its guaranty of interest upon Fours. The Court of Appeals omits to say, or even to suggest, what were the "factors beyond the control of either party" which affected "the ability of South Shore to perform". We can only surmise that the Court of Appeals had in mind the intention which was then in the minds of Canadian and its subsidiary, the Debtor, to have the latter file the reorganization petition at the end of the year.

The District Court, in viewing the matter in a somewhat similar light, made it plain (R., 69) that to that court's mind, the fact that the parties intended in May, 1936, when the guaranty covenant was abrogated, that at about the end of the year a reorganization petition would be filed justified the abrogation.

We submit that the fact that the parties contemplated at the time of the perpetration of the abrogation transaction that, within the course of a few months, a reorganization petition would be filed made a bad matter worse.

The fact that Canadian then contemplated having its subsidiary file the reorganization petition shows beyond

peradventure that, by abrogating its guaranty covenant, it sought to alter the position between it and the only other interested parties in the corporation, viz., the holders of the 5's; that it thus schemed to defeat the rights which the public creditors of its subsidiary would otherwise have had upon this reorganization.

V

In the last paragraph of its opinion the Court of Appeals adverts again to the nature of the rights of the holders of the 5's as third party beneficiaries. The Court says: (R. 96)

> "If, however, it may be said that the owners of South Shore Fives were donee-beneficiaries of the Traffic Agreement, they were the donees of a mere option which required acceptance by them before binding Canadian. They were not creditor-beneficiaries of South Shore because at the time of the execution of the Traffic Agreement its performance did not satisfy 'an actual or supposed or asserted duty' of South Shore to them, nor a right as against South Shore which, by operation of law, was barred or unenforceable. Restatement of the Law of Contracts, Sec. 133. South Shore was not, before the Traffic Agreement was executed, under an obligation claimed or enforceable by the holders of the Fives, to issue four per cent bonds guaranteed by Canadian as to interest, nor to exchange such bonds when issued for the outstanding Fives."

The District Court had held that the holders of the 5's were donee beneficiaries. The Court of Appeals put this aside by stating that they were "donees of a mere option". We submit that thus characterizing their interests does

not militate against their being third party beneficiaries. There is no conceivable reason why a third party beneficiary should not be the beneficiary of a right to make an exchange at his option.

If as the District Court held the holders of the 5's were donee beneficiaries, then it is firmly settled under the law of New York* that their rights were indefeasible.

> *Knowles* v. *Erwin*, 43 Hun. 150, affd. 124, N. Y. 633, 26 N. E. 759;
> *Matter of Fairbairn*, 265 App. Div. 431;
> Restatement of the Law of Contracts, Sec. 142.

Having thus, as it seemed to feel, disposed of the possible position of the holders of the 5's as donee beneficiaries, the Court of Appeals then states that they were not creditor beneficiaries and cites a Section of the Restatement of the Law of Contracts which, narrowly applied, would appear to give some weight to such a view.

The Court of Appeals is apparently laboring under the error that unless the holders of the 5's can be characterized either as donee or creditor beneficiaries there is no remaining category into which they could be fitted and that, therefore, they could have no rights as third party beneficiaries at all.

The following New York decisions demonstrate the error of the Court of Appeals:

Chief Judge Cardozo in *Ultramares Corp.* v. *Touche* (1931), 255 N. Y. 170, at page 180, 174 N. E. 441, at page 445, said:

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*The District Court correctly held that the law of New York applies. See: *McCulloch* v. *Canadian* 53 F. Supp. 540.

> "The assault upon the citadel of privity is proceeding in these days apace. How far the inroads shall extend is now a favorite subject of juridical discussion. (Citing authorities.) In the field of the law of contract there has been a gradual widening of the doctrine of *Lawrence* v. *Fox* (20 N. Y. 268), until today the beneficiary of a promise, clearly designated as such, is seldom left without a remedy (*Seaver* v. *Ransom*, 224 N. Y. 233, 238)."

In *McClare* v. *Mass. Bonding & Ins. Co.* (1935), 266 N. Y. 371, 195 N. E. 15, the Court said at page 379:

> "Starting with the decision in *Lawrence* v. *Fox* (*supra*), permitting a recovery by a third party beneficiary, the courts have tended to permit a recovery where there was revealed a clear intention in the obligation so to do. The requirement of some obligation or duty running from the promisee to the third party beneficiary has been progressively relaxed until a mere shadow of the relationship suffices, if indeed it has not reached the vanishing point."

See also: *Seaver* v. *Ransom*, 224 N. Y. 233, 120 N. E. 639; *Graybar Electric Co.* v. *Seaboard Surety Co.* (1935), 283 N. Y. Supp 522.

In *New York Central Securities Corp.* v. *United States*, 54 F. (2d) 122, several subsidiary railroad corporations controlled by the New York Central Railroad Company, through ownership of nearly all the capital stock, entered into leases with the parent with the approval of the Interstate Commerce Commission. These leases provided that the New York Central Railroad Company, as lessee, should as rent pay certain specified dividends directly to the holders of the minority stock of the subsidiary lessor railroads.

The statutory three judge court said by *Mack,* Circuit Judge, at page 126:

> "The payments of rental dividends are to be made directly to the minority stockholders of the lessors; no payment is made by the lessee to itself as stockholder of the lessors; nor is any rental payment in the form of guaranteed annual dividends paid to the lessor corporations for distribution to their minority stockholders. The minority stockholders are, in effect, third party beneficiaries of the authorized lease agreements, and, as such, have an independent interest, * * *."

This is a clear example of a situation where third party beneficiaries may have enforceable rights even though not standing in the relation of creditors or of kinship to either the promisee or the promisor. The third party beneficiaries in the above cited case would not seem to come within the orthodox classification of either creditor beneficiaries or donee beneficiaries and it is to be noted that Judge *Mack* refrained from classifying them. This and the New York decisions above cited show that it is not important to put the third party beneficiary into a labeled pigeon hole as the Court of the Appeals seems to think.

VI

The courts below in arriving at their conclusions disregarded and gave no weight to the fact that on May 22, 1936, when the guaranty covenant was abrogated, South Shore was insolvent. This gratuitous surrender by South Shore to its parent Canadian was a grave fraud upon its creditors, the public owners of the fives. This should be

regarded as so within the fair intent and purpose of the Elizabethan statute and the cases applying it throughout the centuries, as well as under the Uniform Fraudulent Conveyance Act, which has been adopted, not only by New York, but by most of the states. Section 143 of the Restatement of the Law of Contracts is clear authority that the covenant was indefeasible while South Shore, the promisee, was insolvent.

VII

As the opinion of the District Court clearly shows (R. 67-69) it labored under vital misconceptions in approaching the decision of the case as though it were an ordinary adversary suit and as though the burden was upon the petitioner to prove that the conduct of Canadian was fraudulent and, furthermore, that petitioner was required to establish fraud by direct evidence.

As shown in the opinion of Mr. Justice Brandeis in *First National Bank* v. *Flershem*, 290 U. S. 504, 525, "Moreover, the Court stood in a position different from that which it occupies in ordinary litigation." As Justice Brandeis' opinion shows the Court had the duty to see to it that the interests of the creditors were safeguarded and protected. This abrogation transaction should have aroused the Court to the exercise by it of this duty.

Plainly, also, the burden rested upon Canadian, standing as it did in a fiduciary relation to the holders of the 5's, to justify this abrogation transaction.

However approached, the only proper determination upon the undisputed record is that the abrogation transaction was fraudulent.

Aside from the presumption of fraud arising from the fact of the insolvency of South Shore, the undisputed facts compel a finding of actual fraudulent intent.

Direct evidence as to motives is scarcely ever obtainable and is not required. As correctly said in *20 American Jurisprudence, Evidence*, Section 337:

> "The motive or interest with which an act is done, where material, is generally a matter of inference depending on the nature of the act and the circumstances surrounding its commission,".

We will not here restate the undisputed facts which show the relation of the parties, the circumstances under which this abrogation transaction was perpetrated and the methods employed by Canadian. We submit that these undisputed facts warrant no other ultimate conclusion than that Canadian, in bringing about the abrogation of its guaranty covenant, committed an overreaching and fraudulent act and that the refusal of the Courts below so to determine was an egregious error.

VIII

The cardinal error of the Courts below was their failure to give proper consideration to the fact that Canadian stood in a fiduciary relation to the public holders of the 5s. Although in our briefs and oral arguments we gave emphasis to this and called the attention of the Courts below to the statement made by this Court in *Consolidated Rock Products Co.* v. *Dubois, supra*, that "A holding company, as well as others in dominating or controlling positions, has fiduciary duties to security holders of its system which will be strictly enforced," the Courts below failed to give heed.

Clearly Canadian was not free to deal with this subject matter, as it pleased, in its own interest and as against the interests of the public holders of the 5's toward whom they stood in this fiduciary relation. It could not, with propriety, even countenance this abrogation transaction. For this reason alone the judgments of the Courts below should be reviewed and reversed.

CONCLUSION

This single abrogation transaction compels subordination.

As recently said by the Chief Justice at page 93 of the opinion in *Prudence Realization Corp.* v. *Geist* "the equity powers of the bankruptcy court may be exerted to subordinate the claims of one claimant to those of others of the same class where his conduct in acquiring or asserting his claim is contrary to established equitable principles". In abrogating its guaranty covenant as it did Canadian could have had no other motive than to prevent the calling into play its guaranty obligation. In equity it should be treated as standing in the position of guarantor of interest on the claims of the holders of the 5's at the rate of 4% until the due date of the Consolidated 4% bonds, viz., until 1990.

While the guaranty here is of interest, rather than of principal, the interest period was for such a great number of years that it is virtually an equivalent and for the purposes of passing upon the fairness of a reorganization plan should be so regarded.

The Courts, in passing upon the fairness of a plan of reorganization, wield an equitable discretion almost unbounded. In determining how the interests of a reorganized corporation should be distributed, the Courts do not

compute the remedy by such technical and legalistic calculations as might have to be applied as a rule of damages in a civil law suit. As this Court said in *Consolidated Rock Products Co.* v. *DuBois,* at page 529: "Practical adjustments, rather than a rigid formula, are necessary."

As shown by this Court's opinion in the *Prudence* case (p. 96), in circumstances involving a guaranty where subordination was applied in a reorganization proceeding, the instant case is a striking example for the application of subordination.

We ask that our petition for a writ of certiorari be granted.

Respectfully submitted,

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